REMARKS BY
THOMAS M. DORMAN, EXECUTIVE DIRECTOR
PUBLIC SERVICE COMMISSION
BEFORE THE INTERIM JOINT COMMITTEE ON AGRICULTURE AND NATURAL RESOURCES
JANUARY 10, 2001

My name is Tom Dorman and I'm the Executive Director of the Public Service Commission. I'm here today to discuss the higher natural gas prices that are being experienced by utility customers across the Commonwealth of Kentucky. Let me say up front, that <u>yes</u>, significant price increases for natural gas are being experienced; their impact on natural gas customers across Kentucky is serious; and these increases in price, coupled with a colder-than-normal start to this winter, have resulted in very large increases in customers' natural gas bills.

Increases in natural gas prices are affecting not only Kentucky, but the entire country. According to the federal government, Midwestern U.S. residential natural gas bills for last year, the six months of the 1999-2000 winter heating season, averaged $540 and are projected to average $834 for the current winter heating season. This matches closely with the circumstances in Kentucky. Last year, average residential bills were $507, and are expected to be $827 for this current winter heating season. In January of 2000, average residential usage among Kentucky's 5 major natural gas distribution utilities was 16 Mcf and the average bill for that month was $102. For January 2001, based on that same 16 Mcf usage level and the rates presently in effect, the average bill will be $153, an increase of approximately 50 percent.

According to the national weather service, for the U.S. as a whole, the combined period of November and December 2000 was the coldest on record in over 100 years. Locally, December 2000 was reported as the second coldest on record for Lexington and the coldest ever on record for Louisville. In response to the increases in customers' natural gas bills the Commission has been, and is continuing to work with customers, the gas utilities it regulates, other state government agencies and other states' utility regulatory commissions to address issues related to these price increases and to educate consumers about the impact of these increases and how to try and deal with them.

The Commission became aware that natural gas prices were beginning to increase early this past summer. Last June, when the Commission met with representatives of the 5 major Kentucky gas distribution utilities to discuss the anticipated increases, the Commission indicated to the utilities that it intended to begin publicizing the price increases prior to the end of the summer in order to try and give consumers some advance notice of the increases to help them prepare themselves for the winter heating season. The Commission issued its first press release on this matter on July 13. Over the course of the summer and autumn the gas utilities followed-up by issuing their own press releases and including inserts with their customers' bills to notify them of the increases.

To further investigate this matter, on September 12, the Commission opened a formal proceeding and announced it was going to hold public hearings across the state to gather information concerning the increases in wholesale natural gas prices and the impacts of those increases on the retail customers. The Commission's order opening that case took note that wholesale natural gas prices had increased significantly since the end of last winter's heating season and that natural gas commodity prices in July 2000 were more than double what they had been at the same time in 1999. In October, the Commission held 5 public hearings across the state as part of that investigation and took comments from various stakeholders including intervenor groups, industry groups, and other state agencies that are involved in energy utility issues.

For many years the federal government fully regulated the wholesale price of natural gas. However, it is widely held that that regulation led to the natural gas shortages that were experience in the United States during the 1970s. In response to those conditions the federal government begin removing controls from the price of natural gas during the 1980s and through enactment of the Federal Well-Head Decontrol Act of 1989 fully deregulated natural gas commodity prices as of January 1, 1993. Since then wholesale commodity prices for natural gas have been established by the market forces of supply and demand.

There are two basic components of wholesale natural gas prices: (1) the price of the commodity itself and (2) the price of having the gas transported, or delivered, from the well-head to the distribution utility by one or more pipeline companies. While the commodity price is no longer regulated by the federal government, the transportation charges imposed by the pipelines are regulated by the Federal Energy Regulatory Commission. It is substantial increases in the non-regulated, commodity prices of natural gas over the past several months that are primarily responsible for the increased utility bills that consumers are experiencing so far this winter. For Kentucky's major natural gas distribution utilities, recovery of the wholesale cost of gas makes up, on average, 70 percent of the amount charged a retail residential customer on an average monthly gas bill.

Several factors impacting the price of natural gas have been cited in the course of the Commission's investigation of these increases. Many of these same factors were also cited in hearings held by the Energy and Natural Resources Committee of the United States Senate on December 12, 2000, concerning this same issue. Some of the most noteworthy factors are: (1) natural gas consumption by all retail customer groups has increased, a reflection of the strong national economy in recent years; (2) natural gas consumption for electric generation in particular has increased significantly; (3) low commodity prices in recent years provided little economic incentive for natural gas exploration or production; (4) nationally, going into this winter heating season, natural gas storage levels were lower than at the same time a year ago and also lagged behind the most recent 5-year average; and (5) higher prices for other fuels, such as oil and propane, tend to push natural gas prices higher.

Generally, well-head prices for natural gas have fluctuated within a range of between $2.00 and $3.50 per Mcf in the years since prices were fully deregulated. Spot market prices have recently been in a range of $7.00 to $9.00 per Mcf while contract prices have been somewhat below those levels.

Industry and government agree that one of the major causes of the increasing demand for natural gas is the growth in use of natural gas for electricity generation. This is expected to continue to be the case for at least two decades.

Today, natural gas accounts for about 16 percent of all electricity generation in the U.S. The U.S. Energy Information Administration forecasts that, in 2020, gas will be the fuel for 36 percent of electricity generation. In contrast, coal, the primary fuel for electricity generation for many years, now accounts for 51 percent of generation. In 2020, coal is expected to account for 44 percent.

Let me illustrate this. The U.S. EIA projects that, by 2020, 1310 new power plants (of an assumed average size of 300 megawatts each) will be needed to meet growing electricity demand and to replace aging power plants. Gas technologies, including combustion turbines, combined-cycle units, and distributed generation, are expected to meet 92 percent of the new demand for generating capacity. Coal is expected to meet 6 percent.

The reasons for this greatly increasing demand for natural gas as the fuel for electricity generation are several. Uncertainty about deregulation of the electricity utility industry has caused utilities to defer the very large investment in coal-fired plants. This is estimated by USEIA to be about

$330,000,000 for a 300MW coal-steam power plant as compared to $135,000,000 for a combined-cycle gas plant of the same size. Secondly the uncertainties of changing environmental regulations have given preference to natural gas over coal. Finally, deregulation of the wholesale market for electricity has given rise to a large number of non-utility generators that sell electricity on the wholesale market. These generators typically operate natural gas-fired units that can be sited and built quickly where the market demands them and can be operated at widely varying loads to meet differing and changing market demands.

The increasing generation of electricity by gas-fired plants, and other users, has not only created larger volumes of demand for gas and increased pressure on price. Also, according to the National Petroleum Council, the fact that gas fired plants are often used as peaking plants during the high-demand cooling season, is often preventing stocks from being rebuilt in the summer. Consequently, winter stocks have been lower, causing prices to spike, particularly for consumers, during the winter months.

Kentucky is being effected by the building of new power plants to serve the wholesale market and by the competition between coal-fired and gas-fired generation. Data from the Natural Resources and Environmental

Protection Cabinet and the U.S. Energy Information Administration indicate that, if all the new power plants that have recently been proposed are built in the coming several years, generating capacity in Kentucky will increase dramatically. In 1999, total generating capacity was about 17,000 megawatts. The proposed plants would increase this by over 11,000 megawatts, an increase of 65 percent. It is interesting that the proposed new capacity would be fairly evenly divided between gas-fired (including gas and oil dual capacity) and coal-fired. Gas-fired proposed plants would account for almost 5,500 megawatts. Coal-fired proposed plants would account for almost 4,500 megawatts.

Although demand for natural gas was increasing in recent years, there was excess supply, largely due to the fact that nationally there had been a series of milder than normal winters. This excess supply resulted in depressed wholesale prices which, in turn, depressed drilling and production activity. According to the American Gas Association, when the well-head price of natural gas fell below $2 per Mcf during portions of 1998 and 1999, drilling activity was cut in half from its normal levels. This lack of drilling activity, coupled with the continuing increases in demand, ultimately resulted in the tight natural gas market that began to impact wholesale prices this past summer. In addition to the tightening of the market in terms of supply and demand, other fuels, which in some instances compete with natural gas, began to experience tight markets and increased prices this past summer. Most notable of these was oil and, to a lesser extent, propane. When prices for those fuels began to increase, that exerted additional pressure on the price of natural gas.

The gas distribution utilities regulated by the Commission do not benefit by increases in the wholesale price of natural gas. Their profits are derived from the base rates approved by the Commission for the recovery of costs such as labor, maintenance, depreciation, and taxes. Increases in wholesale gas prices are passed on to retail customers through a Gas Cost Adjustment mechanism, or GCA, which is analogous to the Fuel Adjustment Clause approved for electric utilities. GCA mechanisms have been approved for Kentucky's gas distribution utilities for over 30 years as a means of passing changes in wholesale gas prices on to retail customers in a timely manner without the necessity for a general rate case before the Commission. The GCA mechanism works in both directions, reflecting both increases and decreases in wholesale prices in retail customers' rates.

A utility must receive Commission approval prior to implementing a change in its retail rates to reflect a new Gas Cost Adjustment. The

Commission must determine that the utility's proposed rates are fair, just and reasonable and it does so by reviewing the documentation included in the utility's GCA filing and evaluating the proposed level of gas costs compared to published reports and public indices which track wholesale gas markets and changes in wholesale gas prices in various parts of the country. Only after it has determined that the proposed gas costs are reasonable does the Commission authorize the utility to implement a change in rates which reflects those proposed costs.

Regarding expectations for future natural gas wholesale prices, the Commission has heard much the same as was testified to before the U.S. Senate Energy and Natural Resources Committee this past December. Periods ranging from six months to three years are being projected as the length of time before increases in natural gas drilling activity and production will be expected to significantly affect gas prices. It appears that prices may begin to decline sometime late in 2001 as a result of increases in natural gas supplies brought about by the recent increases in drilling and production activity, but there is little expectation that they will decline to the depressed levels that were being experienced during 1998 and 1999. The Energy Information Administration, projects spot market prices to average somewhere between $5.00 and $6.00 per Mcf for the heating season in the winter of 2001 and 2002.

As I stated earlier, the Commission and the major gas distribution utilities under its jurisdiction began publicizing the price increases this past summer. The utilities have been employing several methods to inform customers about higher gas prices, weatherization and conservation efforts, and low-income assistance programs. These include bill inserts and brochures, television and radio commercials, public billboards, and press releases. This past November Governor Patton and representatives of the 5 major natural gas utilities held a joint news conference concerning these price increases and what customers can do to mitigate the increases in gas prices. In addition, the Governor issued Executive Order 2000-1494 to help customers needing financial assistance from bring cut off from service because they cannot afford to pay the bills. The Governor also made public service announcements that began airing on Kentucky radio stations early this past December regarding what customers can do about the increase in gas prices.

It appears that higher natural gas wholesale prices are not going to go away anytime in the near future. The Commission has been proactive in informing the public of the increases in natural gas prices and will continue to do so. It has also notified the public of the availability of low-income energy assistance programs across the Commonwealth.

The major gas distribution utilities administer assistance programs through which amounts contributed by customers are matched by the utility and donated to various agencies to provide assistance to low-income customers. Some of the utilities have recently announced that they're increasing their matching percentage or are increasing the cap on the amount that they will contribute under such programs.

The Commission wants to emphasize that rising gas prices affect all customers, not only low-income customers. Middle-income customers can be seriously affected by increases in their energy costs. The utilities, with the encouragement of the Commission, are promoting their budget payment plans as a means of mitigating the impacts of higher natural gas prices by spreading the costs over the entire year.

Virtually all the factors that have come together to produce the current situation are outside the control of the natural gas distribution utilities or state utility regulators. While much of the debate at the federal level has focused on a national energy policy and the need of the drilling industry to have access to natural gas reserves located on federally controlled lands, we at the state level must deal with the impact of the cost of energy on the quality of life of our citizens.

Perhaps our most effective efforts under these circumstances are to help Kentuckians understand the circumstances that has brought this about and to make them aware of the tools that are already in place to deal with it.

That concludes my remarks. I'll be happy to try and answer any questions you might have.